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“FERC and State Roles in Implementing a National Energy Strategy”

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Introduction

Good morning. I appreciate the opportunity to address NARUC’s Committee on Gas. Not in recent memory has the topic of a national energy strategy generated so much discussion, and I am pleased that the Committee on Gas has asked the panel to address this issue. Inherent in the word “strategy” is a comprehensive plan, one that aims at long-term solutions. In the context of today’s topic, “strategy” implies to me a comprehensive and environmentally sound plan for ensuring that the nation’s energy supply and demand are kept in reasonable balance, that energy is delivered on a well-organized, efficient and non-discriminatory transportation system, at prices that are just and reasonable, and where customers have a variety of choices.

The Commission’s role in the implementation of a national energy strategy is defined by several statutes, principally the Federal Power Act, the Natural Gas Act, the Natural Gas Policy Act and the Interstate Commerce Act. Of course, Congress may give us additional authority, particularly in electric energy policy. I will outline these thoughts, as well as some measures that states can consider in the context of developing a national energy strategy.

I. Promoting the Development of Necessary Supply

A. Natural Gas Supply Issues

Until recently, concerns about natural gas supply arose during times of peak usage and were a function of seasonal inadequacies in the pipeline grid – bottlenecks in the pipeline network – and not true supply shortages. However, recent volatility in the price of natural gas is being blamed in part on the fact that there was a sharp drop off in exploration activity due to low wellhead prices. In 1998 and 1999, for example, prices were under \$2.00 per Mcf, and several hundred drilling rigs ceased operation. Over the last nine months, natural gas wellhead prices indeed have been high and volatile. Last summer, we saw average wellhead prices increase to the \$4.00 to \$5.00 range, and they averaged \$6.00 to \$10.00 for November and December. Not coincidentally, natural gas demand was up for these two months, which were 16 to 20 percent colder than normal.

Fortunately, over the last few weeks, prices have moderated. The Energy Information Administration now projects that natural gas wellhead prices for the winter months of October, 2000, through March, 2001, will average about \$6.14 per Mcf. This is still more than two and one half times the price prevailing during the previous winter heating season.

So what effect has the increase in wellhead prices had on the exploration for new sources of natural gas? One does not have to be an economist to see a correlation between the increase in average wellhead prices and the dramatic increase in drilling activity. From its two-year low of 371 in April, 1999, to date, the rig count has increased to nearly 900, the highest gas-directed drilling activity since 1985.

High gas prices already have led to calls for the Commission to re-examine its policies, but I continue to have hope that the natural gas market will reach equilibrium between supply and demand at acceptable prices. I have confidence in the efficiency of the natural gas transportation system, which operates generally on a non-discriminatory basis. The industry seems to anticipate capacity needs and to take aggressive measures to ensure the system's reliability, and this involves laying new pipe, adding compression, both supply area and market area storage, and other

system improvements to mitigate delivery bottlenecks and to access new markets and supplies. And new areas of supply are regularly accessed, whether in Canada, the Gulf of Mexico, the Sable Island or elsewhere. In the future, the Commission will no doubt receive a major certificate proposal to access the large natural gas supplies at Prudhoe Bay, Alaska. Producers appear to have reasonable confidence that new supply can be brought to market in a timely and efficient manner.

Thus, in terms of a national energy strategy, I really don't think that the Commission has a need to adopt significant regulatory changes to increase natural gas supplies. The market appears to be giving the right signals, and the industry has been able to respond.

B. Electricity Supply Issues

Turning to the issue of electricity supply, let me make four brief points.

First, most new electric generation has been gas-fired for a variety of good reasons, including the environmental rationale for gas and the confidence that generation developers have in the interstate delivery system for gas. However, high and volatile gas prices can exacerbate high and volatile electricity prices, and we need a better understanding of this relationship. Are generation developers over-relying upon natural gas? I doubt it, but we should have a healthy debate on the appropriate mix of fuel sources for generation – whether renewable, hydro, nuclear, coal or natural gas – necessary to meet our nation's future needs.

One would have to be on another planet not to know that the West is short of generation. We now know that a market that is woefully short of supply is not likely to produce reasonable prices. FERC's role is to facilitate a good market that entices the entry of new generation supply, and I will spend a few minutes on market design a little later.

The siting of new generation resources is, of course, state jurisdictional. My second point, stating the obvious, is that siting processes must keep pace with the needs of the market. Consistent with sound environmental policy, states must streamline their processes and policies to ensure that necessary generation facilities are in place in order for markets to flourish and consumers to benefit.

By the same token, FERC must continue to streamline our processes for licensing hydroelectric facilities.

Point number three is more a comment on market design, but I wanted to mention it here. I am coming to believe that a well-functioning electricity market must have an *ex ante* assurance of adequate generating capacity, including a reserve margin. Given that electricity cannot be stored, relying solely on market signals for capacity could mean significant fluctuations of price and capacity availability as supply and demand seek to remain in balance. One way to guard against fluctuations that threaten reliability would be to place a reserve requirement on the load serving entity that it could meet in the manner it believes most appropriate. PJM takes this approach and, given the level of capacity additions planned there, suppliers seem to have confidence in that market design.

Fourth, new generation cannot serve the market unless it can easily interconnect to the grid. FERC must move toward uniform interconnection policies, procedures and agreements to streamline the interconnection process. We have taken steps in this direction, but now it is time to move forward generically by standardizing generation interconnection across the grid.

II. Promoting Energy Policies that Attract Energy Supply to Open, Transparent and Well-organized Energy Delivery Systems

A. Open Access Issues on the Natural Gas Grid

The next important element of a cogent national energy strategy is a policy that facilitates open, non-discriminatory, transparent and well-organized energy delivery systems. An unbundled, open access interstate pipeline system is two-thirds of the way through its eighth winter, and has been generally successful in meeting the needs of the market.

The era of open access has spurred the creation of new pipeline services that enhance system reliability, such as parking and lending services and hourly services. Third party service providers, particularly storage providers, also provide options for customers that enhance system reliability. Currently, natural gas is traded at over 60 hubs throughout North America and is delivered to LDCs and end users over an extensive pipeline system. Daily price information is available for some 112 trading

points in Gas Daily. Natural gas markets are substantially more open, liquid and transparent than electricity markets.

The interstate portion of the nation's pipeline grid, the part regulated by the Commission, consists of about 280,000 miles of pipeline delivering gas to thousands of delivery points nationwide. The Commission is heavily invested in ensuring that its certificate process functions efficiently so that pipe will be in the ground when and where it is needed. Since joining the Commission in 1993, I cannot remember a single instance where the Commission failed to issue a certificate to a project that met the Commission's minimum filing requirements. Certainly, there have been instances where the Commission has imposed rigorous environmental and other conditions that were warranted by the nature of the comments and protests we received. Nevertheless, over the years from April, 1994, to September, 2000, the Commission certificated almost 10,000 miles of new and replacement pipeline. Moreover, the Commission has taken concrete regulatory steps to expedite the certificate process through our Certificate Policy Statement issued in September, 1999, and in streamlining regulations governing construction under the Commission's blanket certificate program. Over the last two years, the Commission has reduced the average processing time for unprotested cases from 108 days to 95 days. Even for cases that do raise precedential issues, the Commission has seen average case processing time reduced from 300 days to 210 days. In short, the Commission's certificate process is working well to ensure that pipeline capacity is available when and where needed, consistent with our responsibilities under the Natural Gas Act and federal environmental laws.

In addition to pipeline certification, the Commission takes very seriously its responsibilities in overseeing pipeline service offerings to ensure that pipelines operate in a truly open and non-discriminatory manner. One focus of Order No. 637 was to require pipelines to create additional service offerings to provide shippers with imbalance management tools, thereby providing positive incentives for accurate scheduling and decreasing reliance on shipper imbalance penalties. Commission staff have convened technical conferences for most of the interstate pipelines. Thus far, some common themes, such as the feasibility of capacity segmentation, have emerged. Settlement discussions are underway on a number of pipeline systems, but it may be several more months before the process is completed for all the interstate pipelines.

On March 15, at a staff-led technical conference, the Commission will focus on "whether the Commission's regulatory policy with respect to pipeline marketing affiliates and non-affiliates, as well as asset managers and agents, should be revised to reflect the changing nature of the gas market." The Commission is investigating complaints concerning El Paso's marketing affiliate and pipeline capacity into California. Over the last year or so, we have conducted enforcement actions against Columbia, Columbia Gulf and Kinder Morgan, all of which involve their marketing affiliates. Although it is our hope that abuses are the exception rather than the rule, they serve as reminders that the Commission has a crucial interest in monitoring energy markets and in thoroughly airing complaints against both regulated entities and their affiliates. Our pipeline affiliate rules must keep pace with the times. Is the potential for anti-competitive behavior any different if the affiliate is a power marketer or an electric generator, as opposed to the more traditional pipeline marketing affiliate? Should our affiliate code of conduct be extended to all energy affiliates?

In terms of how the Commission's regulation of interstate pipelines plays into the national energy strategy, we must ask hard questions: Is there more the Commission could do to enhance the efficient operation of the nation's interstate natural gas delivery system? Is our certificate policy keeping pace with the times? Should the Commission revise and broaden its affiliate rules? Any new policies should keep these questions in mind.

B. Open Access Transmission Issues in Electricity Markets

When compared to the interstate natural gas grid, the operation of the electric transmission grid is behind the times. We've issued two major policy initiatives attempting to open and rationalize the operation of the electric grid. In Order Nos. 888 and 889, the Commission succeeded in eliminating some of the more blatant forms of discrimination regarding access to the grid. However, our open access rules did nothing to address the splintered way in which the grid is operated and were not successful in eliminating some of the more subtle ways monopoly power is exercised on the transmission grid. In most regions, grid management and power markets remain balkanized and poorly organized. To solve these problems, the Commission adopted Order No. 2000 to promote the development of regional transmission organizations.

I firmly believe that RTOs are absolutely essential for the smooth functioning of electricity markets. RTOs will eliminate the conflicting incentives vertically integrated firms still have in providing open access, streamline interconnection standards and help get new generation into the market.

RTOs also improve grid management. Eliminating pancaked transmission pricing will enlarge markets, and a truly regional approach to congestion management can lower costs and increase the amount of capacity available to the market. RTOs will also serve as a regional forum for planning.

Unfortunately, our RTO policy has been great in concept but woefully inadequate in execution. The fundamental error the Commission made was to choose a voluntary approach to RTO formation. As a result, what we now have before us is a hodgepodge of design and compliance with Order No. 2000. Given this patchwork of proposals and our reliance on voluntary compliance, the Commission is now weakening the Order No. 2000 standards in order to get some RTOs in place. It is no secret that I am deeply concerned about this policy shift.

One area particularly vulnerable is the scope and configuration of RTOs. To realize their many potential benefits, RTOs must be truly regional in scope – large and well shaped. Yet, this is the least clearly defined of the requirements in Order No. 2000. How we treat sub-optimally sized RTO proposals will prove crucial to the development of well functioning markets. Markets are regional in scope and require seamless trading. This is not possible if transmission services and standards remain at an inferior sub-regional level.

Unlike the gas transmission grid, in most electricity markets, the high voltage electricity grid has not expanded to keep pace with the increase in demand. Good markets should over time spur the entry of new generation resources, but I am concerned that necessary interstate transmission facilities are not being built. This may be due in part to regulatory uncertainty, but it may also be rampant NIMBY-ism. I know I won't make any friends here by suggesting this, but perhaps it is time for Congress to consider legislation granting siting authority at the federal level. I can see no reason, logical or legal, for siting decisions involving the interstate transmission of electricity to be treated any differently from siting decisions involving interstate natural gas pipelines. Both activities are inherently interstate in nature. Federal siting authority for electric transmission facilities should be part of our

national energy strategy.

III. Critical Market Design Issues

Now let me turn to the issue of market design, a particularly vexing problem in electricity markets.

Market design is one of those rather technical, nitty gritty issues, perhaps an odd topic to tackle in a presentation on a national energy strategy. Yet if events in the California electricity market have taught us nothing else, at least they have taught us that a poor market design yields poor results, and this cannot be ignored in any energy policy if we are to avoid a duplication of the California debacle.

The first critical market design issue is market power, not simply generation concentration but bidding strategies that are successful in bidding up the price in the wholesale auction. FERC standards for identifying and remedying market power are anachronistic and must be updated. We must devote substantially more manpower to this area, both in market monitoring and in investigating alleged abuses.

We must define market power more precisely and carefully. In the merger context, we must ensure that mergers and consolidations do not undercut the very pro-competitive goals we are promoting. We must evaluate mergers with a sharp eye and rigorous attention to market power standards.

Second, we must insist that there is not an over-reliance on spot markets for electricity purchases. The California spot markets continue to yield extraordinarily high prices, and the wealth transfer from purchasers to sellers is exorbitant. This cannot continue. Soon, not only the purchasing utilities but the State of California itself will be bankrupt if the hemorrhaging continues. Reasonably priced forward contracts are an important part of the solution, both in California and elsewhere.

Third, rational congestion management is looming larger and larger as a critical market design issue. The nodal pricing feature of our best market, PJM, should probably be replicated in every regional market.

Fourth, all of us at both the federal and state levels should focus on facilitating

a robust demand-side response, particularly when prices are high. Any national energy strategy must devote substantially greater attention to the demand-side which, after all, is the other 50% of the market. Large customers in particular must be able not to consume when the price is high. And commitments not to consume, also known as "negawatts," must have the opportunity to bid along with megawatts in the integrated market. Customers must be able to see real-time prices before they consume, and they must have the technology to reduce consumption in response to price signals. This will require the combined efforts of state and federal policy makers, but attention to the demand side, both through conservation and demand-side bidding, must be a part of our strategy.

And fifth, I have discussed already the issue of a reserve requirement, which is looming larger and larger in our consideration of market design.

IV. Balancing Environmental Values with Energy Supply and Facilities Requirements

Let me just comment briefly on this critical element of an energy strategy, and that involves balancing environmental values with energy supply and facilities requirements.

Certainly, we need more supply and facilities both to generate supply and deliver it to the market, but we cannot run rough-shod over environmental values. Environmental values must be respected when decisions are made about facilities siting or fuel choices. This states the obvious, but it must be stated nevertheless.

And building more while consuming more is not always the right balance. A robust conservation program, for example, could very well be the right solution for a thorny problem of electric transmission congestion. Again, I may be stating the obvious, but the demand-side is literally half of the market and cannot be ignored in any comprehensive national energy strategy.

V. Market-based Regulation Must Produce Just and Reasonable Prices

And finally, let me close by stating a principle near and dear to my heart – if a market-based policy is to endure, policy makers must ensure that markets produce just and reasonable prices. Runaway prices, like we have out West in electricity markets, are both unlawful and politically unacceptable. Consumers see these prices as a blatant ripoff, and I fear that we are on the verge of a political backlash. Yes there is a supply shortage out West, but the price signal necessary to attract new generation has been sent in spades.

I believe we need a temporary time out in western electric markets. I would cap bids into the spot markets at variable operating costs plus \$25 per MWh. I would exempt new generation. Without some price mitigation, not only the utilities but the State of California may go broke. The wealth transfer has been enormous and serves no useful public purpose.

The bottom line is that markets must produce reasonable prices. If they do not do so, they will not endure.